



BOARD OF GOVERNORS  
OF THE  
**FEDERAL RESERVE SYSTEM**  
WASHINGTON, D. C. 20551

ALAN GREENSPAN  
CHAIRMAN

January 3, 2006

The Honorable John E. Sununu  
United States Senate  
Washington, D.C. 20510

Dear Senator:

Thank you for inquiring about my views concerning supervision and regulation of government-sponsored enterprises (GSEs) and about how best to focus the GSEs on their public mission without destabilizing the economy. I also appreciate your kind words about my public service on the Federal Reserve Board.

Fannie Mae (Fannie) and Freddie Mac (Freddie) essentially run two lines of business: securitization of mortgage credit and holding of mortgage and other assets for investment purposes. The first line of business provides substantial benefits for affordable housing through the process of using credit guarantees to turn mortgages into marketable securities that trade in public debt markets. This process creates a wide variety of liquidity benefits, some of which flow to homeowners and mortgage originators. Moreover, creating securities from the mortgages extended to nontraditional homeowners is an important step to making mortgage credit more widely available. Focusing Fannie and Freddie on this type of securitization activity can promote affordable housing without creating significant risks to the financial system.

In contrast, once a mortgage has been securitized and sold into the public markets, Fannie's and Freddie's purchases of their own (or each other's) mortgage-backed securities (MBS) for their investment portfolios creates substantial systemic risk while yielding negligible additional benefit for homeowners, renters, or mortgage originators.<sup>1</sup> Under normal circumstances, GSEs are able to easily maintain and grow their large portfolios of mortgage and non-mortgage assets without the significant market checks or balances faced by other publicly traded financial institutions. These large portfolios, while enriching GSE shareholders, do not meaningfully benefit homeowners and do not facilitate secondary market liquidity. They do add systemic risk to our financial system, which normal market forces are unable to resolve.

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<sup>1</sup> For further details, please see my April 2005 testimony before the Senate Committee on Banking, Housing and Urban Affairs, my May 2005 speech under the auspices of the Federal Reserve Bank of Atlanta, and my letters to Senators Bennett and Sununu during the summer of 2005.

In the current system of mortgage financing, the prepayment and interest rate risks associated with mortgages are concentrated in Fannie's and Freddie's large portfolios rather than being more widely dispersed across a broad range of market participants, including the overwhelming number of financial institutions that are significantly less leveraged than the GSEs (such as commercial banks and insurance companies). As Fannie and Freddie increase in size relative to the counterparties for their hedging transactions, their ability to quickly respond to changing market conditions and correct the inevitable misjudgments inherent in their complex hedging strategies becomes more difficult, especially when vast reversal transactions backed by their thin capital holdings are required to rebalance portfolio risks.<sup>2</sup> Furthermore, the success of interest-rate-risk management, especially the exceptionally rapid timing necessitated by dynamic risk adjustments, requires that the ultimate counterparties to the GSEs' transactions provide sufficient liquidity to finance an interest-rate-risk transfer that counters the risk. Otherwise, large and rapid destabilizing adjustments will result in sharp changes in the interest rates required to rebalance and hedge the GSEs' mortgage portfolio.

Also, as I have testified earlier, the GSEs and their government regulator need specific and unambiguous Congressional guidance about the intended purpose and functions of Fannie's and Freddie's investment portfolios. Often, this proposal is referred to as "portfolio limits." The purpose of this guidance, however, is not just to limit the GSEs' portfolios, but to firmly anchor the GSEs' investment portfolios to their public purpose. Strong portfolio guidance by Congress is needed because GSEs are an unusual government intervention in private markets; such institutions lack the typical financial market discipline that is commonplace for other publicly traded firms.

The bill approved by the Senate Banking Committee in July 2005 (S. 190) provides this much-needed anchor and would refocus Fannie and Freddie on their important public policy mission. In addition, S. 190 appropriately strengthens the capital authority of the regulator and establishes a clear and credible receivership process for handling a failed or failing GSE.

In contrast, as I observed during my July 2005 appearances before Congress on monetary policy, the bill that passed the House of Representatives in October 2005 neither takes the steps needed to create an effective GSE regulator nor addresses the systemic risks posed by Fannie's and Freddie's investment portfolios. In the first instance, the House bill fails to sufficiently strengthen the capital authority of the regulator and does not establish a clear and credible receivership process for handling a failed or failing GSE. But, more importantly, the House bill fails to comprehensively address the problem of

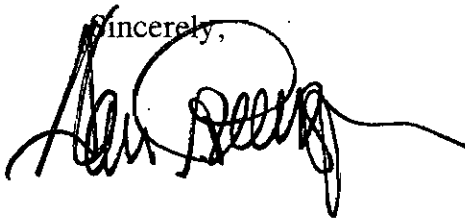
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<sup>2</sup> For mortgage portfolios in particular, misjudgments are inevitable mainly because of the inherent difficulties in forecasting households' prepayment behavior.

systemic risks presented by the GSEs' investment portfolios. Improved regulation by itself may be insufficient and could exacerbate the potential systemic problems associated with the GSEs' large portfolios if financial markets infer from such regulation that the government is more strongly backing GSE debt.

Moreover, the Federal Reserve Board believes that any legislative approach that relies mainly on the future regulator to oversee the GSEs' investment portfolios without providing that regulator with specific and unambiguous Congressional guidance is unlikely to succeed in directing these portfolios toward their important public purposes. Faced with trillions of dollars of assets and the large profits and capital gains created by the perception of government backing, the current GSE regulators have proved unable in recent years to thwart expansionary behavior and focus the GSEs on their important housing mission. The new GSE regulator needs a precise and clear statement from the Congress about the purpose of the GSEs' portfolios in order to assure these portfolios achieve their public mission in a manner that does not run the risk of destabilizing the housing finance markets or the financial system more generally.

Sincerely,

A handwritten signature in black ink, appearing to read "John E. Sununu", with a long horizontal flourish extending to the right.